CITY OF LOS ANGELES

INTEREST RATE RISK MITIGATION POLICY
(SWAP POLICY)

April 2003

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INTRODUCTION

The Interest Rate Risk Mitigation Policy (Swap Policy) has been developed to provide guidelines for the use of interest rate risk mitigation products such as swaps, caps, floors, collars and options in connection with the incurrence of debt obligations included in the City of Los Angeles (the "City") Debt Management Policy (see attached Glossary for further definitions of terms). While the use of these financing products can reduce the City's exposure to interest rate risk on its variable rate debt, careful monitoring of such products is required to preserve the City's credit strength and budget flexibility.

The Office of the City Administrative Officer (the "CAO"), as part of its ongoing responsibility to manage the City's Debt Program, will use these policies in determining the appropriate uses for interest rate risk reduction products and establishing parameters for their use, when recommending is use to the Mayor and City Council. In evaluating a particular transaction involving the use of derivative financing products, the CAO will review the long-term implications associated with entering into such agreements, including costs of borrowing, historical interest rate trends, variable rate capacity, credit enhancement capacity, opportunities to refund related debt obligations and other similar considerations. This analysis would be included in the CAO report recommending a transaction to the Mayor and City Council.

This policy describes the circumstances and methods with which interest rate risk reduction products can be used, the guidelines that will be imposed on them, and who in the City is responsible for implementing these policies.

I. PURPOSES FOR INTEREST RATE RISK MITIGATION PRODUCTS

The purposes for which the City may utilize interest rate risk mitigation products are specified in Section 5922(a) of the Government Code. The CAO will recommend the use of these products only in a manner consistent with this section and only if the Mayor and City Council can make the requisite finding required therein. The purposes for which the City will consider the use of these products are as follows:

1) To prudently reduce exposure to changes in interest rates in the context of a particular financing or the overall asset/liability management of the City; or

2) To achieve a lower net cost of borrowing with respect to the City's debt.

As required by the Government Code, no local agency may enter into any contracts or arrangements unless its governing body first determines that the contract, arrangement or program of contracts is designed to reduce the amount or duration of payment, currency, rate, spread, or similar risk or result in a lower cost of borrowing when used in combination with the issuance of bonds or enhance the relationship between risk and return with respect to the investment or program of investment in connection with, or incident to, the contract or arrangement which is to be entered into. When the CAO recommends the use of interest rate reduction products, the CAO will provide information to the Mayor and City Council necessary to make the determinations required by the Government Code.

II. NO SPECULATION

Interest rate risk mitigation products will not be used for speculative purposes.

III. FORM OF SWAP AGREEMENTS

To the extent possible, the interest rate swap agreements entered into by the City will contain the terms and conditions set forth in the International Swap and Derivatives Association, Inc. ("ISDA") Master Agreement, including any schedules and confirmation. However, the City reserves the right to amend these terms and conditions including the remedies and obligations as is appropriate to benefit the City. The schedule may be modified to reflect specific legal requirements, business terms and changes to the remedies and obligations as determined by the CAO. The CAO will consider whether to include provisions that permit it to assign its rights and obligations under interest rate swap agreements and to optionally terminate the agreement at its market value at any time. The CAO will transmit the proposed Form of Swap Agreements and request authorization from the Mayor and City Council to execute these agreements subject to modifications by the CAO with the assistance of the City Treasurer to be in the best interests of the City.

IV. METHODS TO SOLICIT AND PROCURE INTEREST RATE SWAPS

The CAO will solicit and procure interest rate swaps agreements by competitive bid whenever feasible. The CAO will determine which parties are allowed to participate in a competitive transaction but these parties must conform to the minimum credit standards outlined in this Policy.

Notwithstanding the above, the CAO may procure interest rate swap agreements by negotiated methods if it is determined that due to the size or complexity of a particular interest rate swap competitive bidding is undesirable, impractical or impossible and a negotiated transaction would result in the most favorable pricing.

Such finding will be based on advice by an independent financial advisory firm and with the assistance of the City Attorney. In this situation, the CAO should attempt to price the swap based upon an agreed-to methodology relying on available pricing screens to obtain inputs to a mathematical model. If appropriate, the CAO should use an independent financial advisory firm to assist in the price negotiations.

Regardless of the method of procurement, the CAO will obtain a finding from an independent financial advisory firm that the terms and conditions of interest rate swap agreements reflect a fair market value of such agreement as of the date of its execution.

V. ASPECTS OF RISK EXPOSURE

Before entering into an interest rate swap agreement, the CAO will evaluate the risks inherent in the transaction. The risks to be evaluated could include amortization risk, basis risk, credit risk, counterparty risk, interest rate risk, rollover risk, tax event risk and termination risk. Identification of the risks and discussion of the means, if any, employed to mitigate the risks will be contained in the CAO report recommending to the Mayor and City Council approval of the swap agreements.

A. Amortization Risk

Amortization risk is defined as the mismatch of the expiration of the underlying obligation and its hedge, the swap agreements. Amortization risk is the possibility that as the result of early redemption of the underlying variable rate bonds, the repayment schedule of the bonds differs from the underlying notional amount of the swap agreements. This risk will only arise if the City wants to redeem the variable rate bonds ahead of schedule, which is not expected for most City bond financings. Before undertaking a refunding of the bonds, the CAO will consider the implications on the related swap agreements.

B. Basis Risk

Basis risk refers to the mismatch between the actual variable rate debt service and variable rate index used to determine the swap payments. The CAO will evaluate different swap indices as part of its analysis of the swap agreement and identify the amount of basis risk that may result from various indices.

C. Credit Risk

Credit risk refers to the occurrence of an event modifying the credit rating of the counterparty. Certain interest rate risk reduction products create a continuing exposure to the creditworthiness of financial institutions that serve as the City's counterparties on such transactions. Setting counterparty credit standards that must be met by the counterparty to participate in a transaction can minimize this risk.

D. Counterparty Risk

Counterparty risk refers to the failure of the counterparty to make its required payments. The CAO will endeavor to minimize counterparty risk by establishing strong minimum counterparty credit standards and diversifying the City's exposure to counterparties. To that end, before entering into a transaction, the CAO will analyze the City's existing exposure to that counterparty and then determine how the proposed transaction would affect the exposure. The exposure should not be measured solely in terms of the amount, but rather how changes in interest rates would affect the City's exposure ("Value at Risk"). The Value at Risk should be based on all outstanding swap and interest rate risk reduction agreements of the City.

E. Rollover Risk

Rollover risk refers to the potential need to find a replacement counterparty as part of the overall plan of finance if the interest rate swap does not extend to the final maturity of the underlying variable rate bonds. The rollover risk can be minimized through the initial plan of finance by not relying on the execution of future swap agreements.

F. Tax Events Risk

Tax events risk is defined as the risk created by potential changes to the Federal and State income tax codes on the interest rates to be paid by the City on its variable rate bonds. Tax events risk is a form of basis risk. The CAO will evaluate the potential impact of changes in marginal tax brackets as part of its analysis of basis risk.

G. Termination Risk

Termination risk refers to the possibility that, upon a default by the counterparty, the City may be required to make a large payment to the counterparty if the swap agreement is terminated prior to its scheduled maturity pursuant to its terms. For certain types of swaps, a payment by the City may be required if interest rates have fallen causing the market value of the remaining payments are in favor of the counterparty. The CAO will minimize termination risk by recommending to the Mayor and City Council the selection of counterparties with strong creditworthiness, requiring the counterparty to post collateral in excess of the swap agreement's market value, limiting the circumstances where a payment may be required and permitting the assignment of the agreement to a creditworthy entity in lieu of termination.

VI. COUNTERPARTY CREDIT STANDARDS

To protect the City's interests in the event of a credit problem, the CAO will recommend entering into an interest rate swap agreement with a counterparty only if it meets the following standards:

1) At least two of the counterparty's credit ratings are rated at least "Aa3" or "AA-", or equivalent, by any two of the nationally recognized rating agencies (i.e. Moody's, Standard and Poor's, or Fitch); or

2) The payment obligations of the counterparty are unconditionally guaranteed by an entity with such a credit rating.

VII. COLLATERALIZATION ON DOWNGRADE

The obligations of the counterparty will be collateralized at levels and with securities acceptable to the CAO, as set forth in the swap agreements, should the rating:

1. of the counterparty, if its payment obligations are not unconditionally guaranteed by another entity, or

2. of the entity that unconditionally guarantees its payment obligations, if so secured,

does not satisfy the requirements set forth in Section VI "Counterparty Credit Standards" above.

VIII. TERMINATION

A termination payment to or from the City may be required in the event of termination of an interest rate swap agreement due to a default of either the City or the counterparty, certain additional termination events or optional termination by the City. *Prior to making any termination payment due to the default of counterparty, the CAO will evaluate whether it is financially advantageous for the City to obtain a replacement counterparty to avoid making such termination payment.*

IX. LEGALITY

The City Attorney must receive an opinion reasonably acceptable to the market from a nationally recognized law firm that any interest rate risk mitigation product contracts that the City enters are legal, valid and binding obligations of the City.

X. RESPONSIBILITIES

The CAO is responsible for determining the appropriate uses for interest rate risk mitigation products in conjunction with the City's debt financing and programmatic needs and making recommendations to the Mayor and City Council.

The City Controller is responsible for monitoring and reporting on all City debt obligations and reporting on such debt to the Mayor and City Council. In this capacity, the City Controller will review and report on the activities and assumptions related to the various interest rate risk mitigation transactions. In addition, the Controller is responsible for reflecting the use of interest rate swap agreements and other financing transactions on the City's financial statements in accordance with Generally Accepted Accounting

Principles (GAAP) and with rules promulgated by the General Accounting Standards Board (GASB).

XI. MONITORING AND REPORTING

The CAO will issue a quarterly report to the Mayor and City Council each month following the end of each quarter in which the City enters into or continues to have an interest rate swap agreement. Alternatively, the CAO will include, in a subsequent Financial Status Report, the following information, to the extent applicable:

1) Highlights of all material changes to interest rate swap agreements including counterparty downgrades and/or terminations;

2) A summary of any new interest rate swap agreements entered into by the City since the last report;

3) A summary of any planned interest rate swap transactions and the impact of such transactions on the City;

4) A description of each outstanding interest rate swap agreement, including a summary of its terms and conditions, the notional amount, rates, maturity, the estimated market value of each agreement, the method of procurement (competitive or negotiated), and the full name, description and credit ratings of the agreement's counterparty and, if necessary, its applicable guarantor;

5) Any amounts which were required to be paid and received, and any amounts which actually were paid and received under each outstanding interest rate swap agreement;

6) Any credit enhancement, liquidity facility or reserves associated with the swaps including an accounting of all costs and expenses incurred, whether or not in conjunction with the procurement of credit enhancement or liquidity facilities under each outstanding interest rate swap agreement; and

7) An assessment of the counterparty risk, termination risk, and other risks associated therewith, which will include the aggregate marked to market value for each counterparty and relative exposure compared to other counterparties and a calculation of the City's Value at Risk for each counterparty.

This report will also include a copy of this Policy in the quarter after it is adopted or subsequently modified. The CAO, with the assistance of the City Attorney, the City Controller and the City Treasurer, will periodically review this Policy for changes in best practices (i.e., GFOA Recommended Practices) and recommend modifications to this Policy to the Mayor and City Council.

GLOSSARY OF KEY TERMS

Amortization Risk: Represents the cost to the issuer of servicing debt or honoring swap payments due to a mismatch between bonds and the notional amount of swap outstanding. Amortization risk is characteristic of swaps used to hedge variable rate bonds issued to finance amortizing assets, such as mortgages. Amortization risk occurs to the extent bonds and swap notional amounts become mismatched over the life of a transaction.

Basis Risk: Refers to a mismatch between the interest rate received from the swap contract and the interest actually owed on the issuer's bonds.

Call Option: A contract through which the owner is given the right but is not obligated to purchase the underlying security or commodity at a fixed price within a limited time frame.

Cap: A ceiling on the interest rate that would be paid.

Collar: The combination of owning Cap and selling a Floor. Generally, it is structured so that the net cost of the collar is zero or close to zero. This means that the expense for the long cap premium is offset by the credit received for the floor premium.

Counter Party Risk: The risk that the swap counterparty will not fulfill its obligation to honor its obligations as specified under the contract.

Derivative: A financial product that is based upon another product. Generally, derivatives are risk mitigation tools.

Floor: A lower limit on the interest rate that would be paid.

Interest Rate Risk: The risk associated with changes in general interest rate levels or Yield Curves (see Yield Curves below).

Interest Rate Swap: The contract whereby one party typically agrees to exchange a floating rate for a fixed coupon rate. An essential characteristic of swaps is the swapping of cashflows and not principal amounts.

ISDA: The International Swaps and Derivatives Association, a global trade association representing participants in the derivatives industry.

Notional Amount: The stipulated principal amount for a swap transaction. There is no transfer of ownership in the principal for a swap; but there is an exchange in the cash flows for the designated coupons.

Option: A derivative contract. There are two primary types of options (see Put Option and Call Option). An option is considered a wasting asset because it has a stipulated life to expiration and may expire worthless. Hence, the premium could be wasted.

Put Option: A contract that grants to the purchaser the right but not the obligation to exercise.

Rollover Risk: The risk that the swap contract is not coterminous with the related bonds.

Swap: A customized financial transaction between two or more counterparties who agree to make periodic payments to one another. Swaps cover interest rate, equity, commodity and currency products. They can be simple floating for fixed exchanges or complex hybrid products with multiple option features.

Tax Events Risk: Issuers that issue tax-exempt variable rate bonds inherently accept risk stemming from changes in marginal income tax rates. This is due to the tax code's impact on the trading value of tax-exempt bonds. This risk is also a form of basis risk under swap contracts.

Termination Risk: The risk that the swap could be terminated by the counterparty due to any of several events, which may include issuer or counterparty ratings downgrade, covenant violation by either party, bankruptcy of either party, swap payment default by either party, and default events as defined in the issuer's bond indenture. The events of default and termination, which could lead to involuntary termination of the contract, would include failure to pay, bankruptcy, merger without assumption of obligations and legality.

Yield Curve: Refers to the graphical or tabular representation of interest rates across different maturities. The presentation often starts with the shortest-term rates and extends towards longer maturities. It reflects the market's views about implied inflation/deflation, liquidity, economic and financial activity, and other market forces.

CITY OF LOS ANGELES

VARIABLE RATE DEBT POLICY

APRIL 2003

CITY OF LOS ANGELES
VARIABLE RATE DEBT POLICY

INTRODUCTION

The municipal bond market has developed several vehicles by which municipalities can borrow at variable interest rates, including variable rate demand obligations, commercial paper, and auction rate securities. These products are structured as a rolling series of short-term investments that are resold periodically, and therefore are priced at the short-end of the yield curve at low interest rates. By accepting the risks inherent in variable interest rates, the City, as the issuer, can take advantage of the lowest rates available on the current market. As part of its ongoing responsibility, the City Administrative Officer (the "CAO") will use this policy to manage these risks while taking advantage of this low-cost borrowing tool.

I. PURPOSES OF VARIABLE RATE DEBT

Variable interest rate debt instruments may be used for the following purposes:

1) **As a balance sheet management tool, offsetting the risks inherent in variable rate assets.** The maintenance of variable rate debt liabilities in an amount equal to or less than the amount of variable rate assets prudently reduces the City's risk of exposure to changes in interest rates. For example, the City currently maintains significant exposure from variable rate assets in the form of the short-term investment of available cash, while a large portion of its liabilities are in the form of fixed-rated debt. When interest rates fall, the budget experiences reduced revenues. Offsetting this exposure with variable rate liabilities would serve to hedge against such interest rate risk. The CAO will provide an analysis of asset and liability balance on a fund-by-fund basis and include it in its report to the Mayor and City Council when recommending variable rate debt.

2) **To achieve an expected lower net cost of borrowing with respect to the City's debt by accepting a limited level of interest rate risk.** Since the inception of municipal variable rate products in the early 1980's, variable interest rates have borne an average rate that is substantially below the average for fixed rates. For example, since 1990, the average rate on California variable rate bonds has been 3.25%, substantially lower than the lowest 30-year rate experienced over this same period (5%). Accordingly, issuers who have accepted variable rate risk have experienced reduced costs of borrowing. One of the goals of this policy is to define a prudent range of risk exposure.

3) **As a tool for interim financing.** Since the expectations of variable-rate investors are, by their nature, short-term variable rate debt can be redeemed at short notice without any penalty in the form of a call premium or higher initial interest rates. This feature makes variable rate debt a preferred tool for financing projects for which a prepayment or restructuring is a high probability. Certain variable rate products—most notably, commercial paper—can be issued incrementally as funds are needed to finance current construction, and can reduce the long-term cost of construction financing. Often, commercial paper will be refunded with a long-term financing when the project is completed.

II. CRITERIA FOR USE OF VARIABLE RATE DEBT

The following criteria set forth the City's policy for using variable rate debt. Any staff recommendation for the use of variable rate debt must make findings consistent with these criteria.

1. **Balance sheet risk mitigation:** In determining the appropriate amount of variable rate debt to be issued for risk mitigation purposes, the following factors should be taken into account, and analyzed on the basis of the fund or funds that will be repaying the debt:

    - The historic average of cash balances analyzed over the course of several prior fiscal years.
    - Projected cash balances based on known demands on a given fund and on City fund balance policies.
    - Any basis risk, such as the difference in the performance or duration of the City's investment vehicle compared to the variable rate debt instrument to be used by the City.

2. **Risk exposure:** It may be appropriate for the City to accept a moderate exposure to interest rate risk to benefit from what has been the historic out-performance of the variable rate market. This Policy incorporates the rating agency guidelines that 20% to 25% of outstanding debt can be in a variable rate mode without representing undue risk. In determining the amount of such risk the City should take, the CAO should consider the specific fund exposed to the risk, and the budgetary flexibility that fund has in accommodating such risk. The analysis of risk exposure should be performed on the basis of "net" risk; that is, variable rate liability exposure net of any interest rate hedge provided by the availability of cash or risk mitigation tools such as interest rate swaps.

3. **Interim financing:** The City should consider issuing commercial paper in connection with its major debt-financed construction programs, especially when interest earnings on construction and capitalized interest funds are at a rate lower than the rate of long-term bonds, thereby increasing the amount of debt

that must be issued to fund a program. Variable rate debt should also be considered in lieu of a long-term fixed rate financing when a refunding or restructuring of the debt is likely due to potential changes in use of the project or credit quality.

4. **Synthetic fixed rate:** In some markets, the City can simultaneously issue variable rate debt and enter into corresponding swap agreements that have the effect of creating a net fixed rate obligation at a significantly lower net interest cost than the cost of issuing traditional fixed rate debt. The use of variable rate debt should be considered in those instances where the issuance of synthetic fixed rate debt is a viable and cost-effective alternative, subject to the provisions of the City's swap policies.

III. DIVERSIFICATION OF REMARKETING AGENTS & COUNTERPARTIES

In selecting remarketing agents for its various variable rate programs, the City should chose remarketing agents that diversify its exposure and create competition among the various remarketing agents.

Similarly, in selecting institutions to provide liquidity or credit enhancement, the City should seek to diversify its counterparties.

IV. BUDGETING

The CAO will determine the appropriate method for budgeting each variable rate bond program, considering historic interest rates, projected interest rates, the effect of risk mitigation products such as interest rate swaps or caps, and the availability of fund balances carried-forward from savings from previous years. This analysis would be done in conjunction with the formulation of the Mayor's Proposed Budget.

V. MONITORING AND REPORTING

The CAO will manage the City's variable rate programs, including the performance of actual interest rates compared to the interest rates assumed at the time of budget formulation. The CAO will recommend any appropriate mid-year budget adjustments.

The Controller will be responsible for monitoring the City's variable debt programs and will report as appropriate to the Mayor and City Council in accordance with the Controller's Charter responsibilities. In addition, the Controller is responsible for reflecting variable rate debt in accordance with Generally Accepted Accounting Principles (GASP) and with rules promulgated by the General Accounting Standards Board (GASB).

The CAO will review and report on the following on a periodic basis:

1. Whether balances remaining at the end of the fiscal year, accruing from actual lower interest rates than those assumed in the budget process, will be reserved for future interest rate stabilization or otherwise applied for interest rate management.

2. The performance of the individual remarketing agents as compared to other remarketing agents, other similar programs and market indices.

3. The factual circumstances, such as balance sheet factors or the relative amount of debt that supported the original issuance of variable rate debt.

The CAO, with the assistance of the City Attorney, the City Controller and the City Treasurer, will periodically review this Policy for changes in best practices (i.e., GFOA Recommended Practices) and recommend such changes to this Policy to the Mayor and City Council.